

Tobacco Settlement Authority
(A Component Unit of the State of Iowa)

Financial Report
June 30, 2012

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Independent Auditor's Report

The Board of the Tobacco Settlement Authority
Des Moines, Iowa

We have audited the accompanying financial statements of the governmental activities and the General Fund of the Tobacco Settlement Authority (the Authority), a component unit of the State of Iowa, as of and for the year ended June 30, 2012, which collectively comprise the Authority's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Authority's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and the General Fund of the Tobacco Settlement Authority, as of June 30, 2012, and the respective changes in financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 30, 2012, on our consideration of the Authority's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3 through 6 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

McGladrey LLP

Des Moines, Iowa
November 30, 2012

**Tobacco Settlement Authority
(A Component Unit of the State of Iowa)**

**Management's Discussion and Analysis
Year Ended June 30, 2012**

We present the financial statements of the Tobacco Settlement Authority (the Authority) and offer readers of these financial statements this narrative overview and analysis of the financial activities of the Tobacco Settlement Authority for the year ended June 30, 2012.

Overview of Authority

In 2001, the Authority purchased all payments required to be made by tobacco product manufacturers to the State of Iowa and the State's rights to receive such payments pursuant to the Master Settlement Agreement. As consideration for 78 percent of the payments, the Authority distributed approximately \$579 million of net proceeds to the State from the issuance of bonds.

In 2005, the Authority issued approximately \$832 million of Tobacco Settlement Asset-Backed Bonds. The proceeds of the 2005 bonds were used to refund the Series 2001 bonds, fund a debt service reserve account, pay costs of issuance and provide approximately \$154 million in net proceeds to the State. The Series 2005 bonds are special revenue obligations of the Authority and are payable solely from pledged tobacco settlement revenues, amounts held in the debt service reserve account and investment income.

In fiscal year 2012, the primary activity of the Authority was the investment of bond reserves, the payment of administrative and enforcement expenses and the payment of principal and interest on the Series 2005 bonds. During the year, the Authority received \$51,207,875 in tobacco settlement revenues.

Overview of the Financial Statements

This Discussion and Analysis is intended to serve as an introduction to the Authority's basic financial statements. The Authority's basic financial statements are comprised of three components: 1) government-wide financial statements, 2) fund financial statements and 3) notes to financial statements.

Government-wide financial statements: The government-wide financial statements are designed to provide readers with a broad overview of the Authority's finances, in a manner similar to a private-sector business.

The Statement of Net Assets presents information on all of the Authority's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the Authority is improving or deteriorating.

The Statement of Activities presents information showing how the Authority's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods.

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**Management's Discussion and Analysis
Year Ended June 30, 2012**

Fund financial statements: A fund is a grouping of related accounts used to maintain control over resources segregated for specific activities or objectives. Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on near-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating the Authority's near-term financial requirements.

Because the focus of governmental funds is narrower than the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the Authority's near-term financing decisions. Both the governmental fund Balance Sheet and the governmental fund Statement of Revenues, Expenditures and Changes in Fund Balance (Deficit) provide a reconciliation to facilitate this comparison between governmental funds and governmental activities.

Notes to financial statements: The notes provide additional information essential to a full understanding of the data provided in the government-wide and fund financial statements.

Government-Wide Financial Analysis

The Authority has total deficit net assets as of June 30, 2012 and 2011. This indicates the Authority's liabilities, primarily the bonds, exceed the Authority's ability to pay those liabilities without additional funding. This is expected since debt service on the bonds is to be paid from future tobacco settlement revenues.

Table 1 reflects total deficit net assets of \$(206,743,989) as of June 30, 2012, which represents a decrease of \$48,129,788 from June 30, 2011. The Authority's total assets decreased \$51,458,899, primarily due to a decrease in the advance to the State. Total liabilities decreased \$3,329,111, primarily due to the repayment of debt.

**Tobacco Settlement Authority
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**Management's Discussion and Analysis
Year Ended June 30, 2012**

Table 1 - Authority's Net Assets

	Governmental Activities	
	June 30,	
	2012	2011
Assets		
Current assets	\$ 157,425,524	\$ 133,482,105
Noncurrent assets	390,913,444	466,315,762
Total assets	548,338,968	599,797,867
Liabilities		
Current liabilities	102,945,012	79,202,016
Long-term liabilities	652,137,945	679,210,052
Total liabilities	755,082,957	758,412,068
Net Assets (Deficit)		
Restricted for debt service	79,279,770	79,589,421
Unrestricted	(286,023,759)	(238,203,622)
Total net assets (deficit)	\$ (206,743,989)	\$ (158,614,201)

Table 2 highlights the Authority's revenues and expenses for the years ended June 30, 2012 and 2011. This table utilizes the full accrual method of accounting.

Table 2 - Authority's Changes in Net Assets

	Governmental Activities	
	Year Ended June 30,	
	2012	2011
General revenues, investment income	\$ 2,632,296	\$ 2,635,055
Expenses:		
Current:		
Administrative	58,497	69,101
Enforcement	1,378,076	1,103,336
Debt service, interest	49,158,888	49,456,202
Amortization	166,623	166,624
Total expenses	50,762,084	50,795,263
Decrease in net assets	(48,129,788)	(48,160,208)
Net assets (deficit), beginning of year	(158,614,201)	(110,453,993)
Net assets (deficit), end of year	\$ (206,743,989)	\$ (158,614,201)

**Tobacco Settlement Authority
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**Management's Discussion and Analysis
Year Ended June 30, 2012**

Financial Analysis of the Governmental Fund

As noted earlier, the Authority uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. The fiscal year 2012 ending fund balance of the Authority's governmental fund decreased \$51,364,481 from fiscal year 2011. The decrease is due primarily to the principal and interest payment made in the current year. The ending fund balance is restricted for debt service.

Debt Administration

As of June 30, 2012 and 2011, the Authority had \$751,290,052 and \$754,639,422, respectively, in outstanding revenue bonds. In the current year, the Authority paid \$9,590,000 of principal and incurred \$49,158,888 of interest on outstanding debt.

Additional information about the Authority's long-term debt can be found in Note 3 to the financial statements.

Table 3 - Outstanding Debt, June 30

	Governmental Activities	
	2012	2011
Term bonds	\$ 560,265,000	\$ 569,855,000
Convertible capital appreciation bonds	178,010,000	178,010,000
Capital appreciation bonds	551,790,000	551,790,000
Less deferred amount	(538,774,948)	(545,015,578)
Total	<u>\$ 751,290,052</u>	<u>\$ 754,639,422</u>

Economic Factors

The Authority pledged all surplus collections, if any, to the turbo redemption of the Series 2005 bonds. Tobacco settlement revenue, the primary revenue source for the Authority, is dependent on future tobacco product sales. The amount of future revenue recognized by the State of Iowa and provided by the Tobacco Settlement Authority could, therefore, be adversely impacted by consumption trends within the tobacco industry.

Requests for Information

These financial statements and discussion are designed to provide our citizens, taxpayers, investors and creditors with a complete disclosure of the Authority's finances and to demonstrate a high degree of accountability. If you have questions about this report or need additional information, please contact the State Treasurer's Office, Lucas State Office Building, Des Moines, Iowa 50319.

Tobacco Settlement Authority
(A Component Unit of the State of Iowa)

Governmental Fund Balance Sheet/Statement of Net Assets (Deficit)
June 30, 2012

	General Fund Balance Sheet	Adjustments	Statement of Net Assets (Deficit)
Assets			
Current assets:			
Cash on deposit with Treasurer of State	\$ 4,762,788	\$ -	\$ 4,762,788
Due from the State	50,730,566	-	50,730,566
Advance to the State	101,718,793	-	101,718,793
Interest receivable, restricted	213,377	-	213,377
Total current assets	157,425,524	-	157,425,524
Noncurrent assets:			
Restricted assets:			
Cash and cash equivalents	19,867,477	-	19,867,477
Investments	59,198,916	-	59,198,916
Advance to the State	309,347,700	-	309,347,700
Deferred charges	-	2,499,351	2,499,351
Total noncurrent assets	388,414,093	2,499,351	390,913,444
Total assets	\$ 545,839,617	2,499,351	548,338,968
Liabilities			
Current liabilities:			
Accounts payable	\$ 181,033	\$ -	\$ 181,033
Due to the State	130,201	-	130,201
Bonds payable, current portion	-	101,718,793	101,718,793
Unamortized bond discount, current portion	-	(774,797)	(774,797)
Unamortized deferral on refunding, current portion	-	(1,791,889)	(1,791,889)
Accrued interest payable	-	3,481,671	3,481,671
Total current liabilities	311,234	102,633,778	102,945,012
Noncurrent liabilities:			
Bonds payable, net of current portion	-	693,492,297	693,492,297
Unamortized bond discount, net of current portion	-	(16,267,905)	(16,267,905)
Unamortized deferral on refunding, net of current portion	-	(25,086,447)	(25,086,447)
Total noncurrent liabilities	-	652,137,945	652,137,945
Total liabilities	311,234	754,771,723	755,082,957
Fund balance			
Restricted for debt service	545,528,383	(545,528,383)	-
Total liabilities and fund balances	\$ 545,839,617	\$ 209,243,340	\$ 755,082,957
Net assets (deficit)			
Restricted for debt service		\$ 79,279,770	\$ 79,279,770
Unrestricted		(286,023,759)	(286,023,759)
Total net assets (deficit)		\$ (206,743,989)	\$ (206,743,989)

See Notes to Financial Statements.

Tobacco Settlement Authority
(A Component Unit of the State of Iowa)

Reconciliation of the Governmental Fund Balance Sheet to the Statement of
Net Assets (Deficit)
June 30, 2012

Amounts reported for governmental activities in the Statement of Net
Assets (Deficit) are different because:

Total fund balance for the governmental fund	\$ 545,528,383
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Long-term liabilities applicable to governmental activities are not due and payable in the current year and, accordingly, are not reported as fund liabilities. Interest on long-term debt is not accrued in the governmental fund, but rather is recognized as an expenditure when due. All liabilities, both current and long-term, are reported in the Statement of Net Assets (Deficit).

Accrued interest on bonds	(3,481,671)
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Bonds payable	\$ (795,211,090)	
Unamortized deferral on refunding	26,878,336	
Unamortized bond discount	17,042,702	
Unamortized deferred charges	2,499,351	(748,790,701)
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Total net assets (deficit) of governmental activities		<u>\$ (206,743,989)</u>
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See Notes to Financial Statements.

Tobacco Settlement Authority
(A Component Unit of the State of Iowa)

Statement of Revenues, Expenditures and Changes in Fund
Balance/Statement of Activities
Year Ended June 30, 2012

	General Fund		
	Statement of		
	Revenues,		
	Expenditures		
	and Changes in		
	Fund Balance	Adjustments	Statement
			of Activities
General revenues, investment income	\$ 2,632,296	\$ -	\$ 2,632,296
Expenditures/expenses:			
Current:			
Administrative	58,497	-	58,497
Enforcement	1,378,076	-	1,378,076
Debt service:			
Principal	9,590,000	(9,590,000)	-
Interest	42,970,204	6,188,684	49,158,888
Amortization of bond issuance costs	-	166,623	166,623
Total expenditures/expenses	53,996,777	(3,234,693)	50,762,084
Net change in fund balance/net assets (deficit)	(51,364,481)	3,234,693	(48,129,788)
Fund balance/net assets (deficit), beginning of year	596,892,864	(755,507,065)	(158,614,201)
Fund balance/net assets (deficit), end of year	<u>\$ 545,528,383</u>	<u>\$ (752,272,372)</u>	<u>\$ (206,743,989)</u>

See Notes to Financial Statements.

Tobacco Settlement Authority
(A Component Unit of the State of Iowa)

**Reconciliation of the Statement of Revenues, Expenditures and
Changes in Fund Balance (Deficit) to the Statement of Activities**
Year Ended June 30, 2012

Amounts reported for governmental activities in the Statement of Net
Assets (Deficit) are different because:

Net change in fund balance (deficit) for the governmental fund	\$ (51,364,481)
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Repayment of bond principal is an expenditure in the governmental fund but reduces the liability in the Statement of Net Assets (Deficit)	9,590,000
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Under the modified accrual basis of accounting used in governmental
funds, expenditures are not recognized for transactions normally paid
with expendable available resources. In the Statement of Activities,
however, which is presented on the accrual basis, expenses and liabilities
are reported regardless of when financial resources are available.
In addition, interest on long-term debt is not recognized under the modified
accrual basis of accounting until due rather than when it
accrues. This adjustment combines the net changes of five balances.

Amortization of bond issuance costs	\$ (166,623)	
Amortization of advanced refunding difference	(1,791,889)	
Amortization of bond discount	(786,357)	
Accretion of interest on capital appreciation bonds	(3,662,384)	
Accrued interest on bonds	51,946	(6,355,307)
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Decrease in net assets of governmental activities		\$ (48,129,788)

See Notes to Financial Statements.

**Tobacco Settlement Authority
(A Component Unit of the State of Iowa)**

Notes to Financial Statements

Note 1. Nature of Operations, Reporting Entity, Measurement Focus and Basis of Accounting and Significant Accounting Policies

Nature of operations:

The Tobacco Settlement Authority (the Authority) was authorized by the provisions of Chapter 12E of the Code of Iowa on May 19, 2000. The purposes of the Authority include to: (a) implement and administer a program plan and to establish a stable source of revenue to be used for purposes designated in Chapter 12.65 of the Code of Iowa, (b) enter into sales agreements, (c) issue bonds and enter into funding options, including refunding and refinancing its debt and obligations, (d) sell, pledge or assign as security all or a portion of the State of Iowa's (State) share to provide for and secure the issuance of its bonds, (e) invest funds available to provide for a source of revenue in accordance with the program plan, (f) enter into agreements with the State for the periodic distribution of amounts due the State under any sales agreement, (g) refund and refinance the Authority's debts and obligations and to manage its funds, obligations and investments, as necessary, (h) sell, pledge or assign, as security or consideration, all or a portion of the State's share to implement alternative funding options and (i) implement the purposes of Chapter 12E of the Code of Iowa.

Reporting entity:

The Authority is a component unit of the State of Iowa (the State). The basic financial statements of the Authority are included in the State's Comprehensive Annual Financial Report.

The Authority has considered all potential component units for which it is financially accountable and other organizations for which the nature and significance of their relationship with the Authority are such that exclusion would cause the Authority's basic financial statements to be misleading or incomplete. The Governmental Accounting Standards Board (GASB) has set forth criteria to be considered in determining financial accountability. These criteria include appointing a voting majority of an organization's governing body and (1) the ability of the Authority to impose its will on that organization or (2) the potential for the organization to provide specific benefits to or impose specific financial burdens on the Authority. The Authority has no component units which meet the GASB criteria.

Measurement focus and basis of accounting:

The Authority-wide basic financial statements are reported using the "economic resources measurement focus" and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows.

**Tobacco Settlement Authority
(A Component Unit of the State of Iowa)**

Notes to Financial Statements

Note 1. Nature of Operations, Reporting Entity, Measurement Focus and Basis of Accounting and Significant Accounting Policies (Continued)

Governmental fund basic financial statements are reported using the "current financial resources measurement focus" and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current year or soon enough thereafter to pay liabilities of the current year. For this purpose, the Authority considers revenues to be available if they are collected within 60 days after the end of the current fiscal year. Expenditures generally are recorded when a liability is incurred, as under accrual accounting. However, debt service expenditures are recorded only when payment is due.

Authority-wide and fund basic financial statements: The basic financial statements combine both an Authority-wide perspective and a governmental fund perspective.

The Authority is classified as a Special Revenue Fund in the State's Comprehensive Annual Financial Report. Special revenue funds account for the proceeds of specific revenue sources (other than permanent or capital projects) legally restricted to expenditure for a specified purpose. The difference between assets and liabilities is referred to as "fund balance."

The Authority-wide basic financial statements, the Statement of Net Assets (Deficit) and the Statement of Activities, report information on all of the activities of the Authority. Governmental activities generally are those normally financed through taxes, intergovernmental revenues and other nonexchange revenues.

The Authority's board consists of the Treasurer of State, the Auditor of State and the Director of the Department of Management of the State.

Master Settlement Agreement: On November 23, 1998, a Master Settlement Agreement (MSA) was entered into between 46 states (including the State of Iowa) and the four major tobacco industry manufacturers. The MSA represents the resolution of a large potential financial liability of the tobacco industry manufacturers for smoking-related injuries. The 46 states agreed to settle all past, present and future smoking-related claims against the tobacco industry manufacturers in exchange for agreements and undertakings by the tobacco industry manufacturers concerning a number of issues.

The MSA sets forth the schedule and calculation of payments to be made by the tobacco industry manufacturers to the states. These payments are subject to various adjustments and offsets. Payments to be received under the MSA include:

- Five initial payments, the last of which was paid in January 2003,
- Annual payments which are required to be made on April 15 of each year and will continue in perpetuity and
- Ten strategic contribution fund payments which are required to be made annually on April 15, from April 15, 2008 through April 15, 2017.

**Tobacco Settlement Authority
(A Component Unit of the State of Iowa)**

Notes to Financial Statements

Note 1. Nature of Operations, Reporting Entity, Measurement Focus and Basis of Accounting and Significant Accounting Policies (Continued)

Program Plan: Chapter 12E.10 of the Code of Iowa directs the Authority to establish a Tobacco Settlement Program Plan (Program Plan) to provide the State with a secure and stable source of revenue for the purposes designated in Chapter 12.65 of the Code of Iowa. These purposes relate to health care, substance abuse treatment and enforcement, tobacco use prevention and control and other purposes related to the needs of children, adults and families in the State and to create a savings account for healthy Iowans invested to provide an ongoing source of investment earnings.

The Program Plan was submitted to the Legislature and the Executive Council of the State. Implementation of the Program Plan was authorized by a constitutional majority of each house of the General Assembly and approved by the Governor of the State.

Sales Agreement: Upon approval of the Program Plan, the State and the Authority entered into a sales agreement in which the State agreed to sell the Authority all of its right, title and interest in certain amounts payable to the State under the MSA. In return, the Authority agreed to issue tobacco settlement bonds and remit the net bond proceeds and any unpledged moneys to the State.

Tobacco Settlement Asset-Backed Bonds, Series 2001: The Authority issued Tobacco Settlement Asset-Backed Bonds, Series 2001 (Series 2001 Bonds), dated October 25, 2001, in the amount of \$644,245,000. The Series 2001 Bonds were advance refunded from the proceeds of the Tobacco Settlement Asset-Backed Bonds, Series 2005, issued November 30, 2005.

Tobacco Settlement Asset-Backed Bonds, Series 2005: The Authority issued Tobacco Settlement Asset-Backed Bonds, Series 2005 (Series 2005 Bonds), dated November 30, 2005, in the amount of \$831,962,030.

The Series 2005 Bonds contain turbo redemption features which require all tobacco revenue collections in excess of operating expenditures and scheduled debt service be applied to the redemption of the bonds. The turbo redemptions are not scheduled amortization payments and are to be made only from surplus collections, if any. Failure to make a turbo principal payment will not constitute default.

**Tobacco Settlement Authority
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Notes to Financial Statements

Note 1. Nature of Operations, Reporting Entity, Measurement Focus and Basis of Accounting and Significant Accounting Policies (Continued)

Significant accounting policies:

The basic financial statements of the Authority have been prepared in conformity with U.S. generally accepted accounting principles, as applied to governmental units. The more significant of the Authority's accounting policies are described below.

Cash equivalents: The cash balances of the Authority are pooled and invested by the Treasurer of State. All highly liquid investments with a maturity of three months or less when purchased are considered to be cash equivalents. Investments not meeting the definition of cash equivalents as of June 30, 2012 include a guaranteed investment contract totaling \$59,198,916.

Investments: Investments in guaranteed investment contracts are reported at cost determined by the fund's contract value, plus interest earned.

Due from the State/advance to the State: The receivable consists primarily of the amount the State of Iowa has committed from the future amounts to be received by the State under the Master Settlement Agreement.

Deferred charges: Deferred charges represent bond issuance costs which are deferred and amortized as an adjustment to interest expense over the life of the related bond issue using the straight-line method, which approximates the effective interest method.

Bonds payable: The Authority reports bonds payable at face value, net of discounts and accretion of capital appreciation. Bond discounts and issuance costs are capitalized and amortized using the effective interest method over the life of the related debt in the Authority-wide basic financial statements. The governmental fund basic financial statements recognize bond discounts, as well as bond issuance costs, in their entirety, during the current year. Issuance costs, whether or not withheld from the actual debt proceeds received, are reported as expenditures. Gains and losses associated with the reacquisition of bonds payable are amortized over the remaining life of the refunded debt for the Authority-wide basic financial statements. In the Authority-wide financial statements, such gains and losses arise from the difference between the repurchase price and the par value of the bonds, along with any forfeited unamortized bond discount and costs of issuance amounts.

Interest expense is recognized on the accrual basis in the Authority-wide basic financial statements. Interest expenditures are recognized when paid in the governmental fund basic financial statements.

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Notes to Financial Statements

Note 1. Nature of Operations, Reporting Entity, Measurement Focus and Basis of Accounting and Significant Accounting Policies (Continued)

Fund balance: In the governmental fund financial statements, the fund balance is classified as restricted. Amounts are restricted to specific purposes when constraints placed on the use of the resources are either externally imposed by creditors, grantors or state or federal laws or imposed by law through constitutional provisions or enabling legislation.

Net assets: Net assets represents the difference between assets and liabilities. Net assets are reported as restricted when there are limitations imposed on their use through enabling legislation or through external restrictions imposed by creditors, grantors or laws or regulations of other governments. The Authority has restricted net assets of \$79,279,770 for debt service by debt agreement and sales agreement. The Authority first applies restricted resources when an expense is incurred for purposes for which both restricted and unrestricted net assets are available.

Use of estimates: Management of the Authority has made a number of estimates and assumptions relating to the reporting of assets, liabilities, revenues and expenses and the disclosure of contingent assets or liabilities to prepare these basic financial statements in conformity with U.S. generally accepted accounting principles. Actual results could differ from those estimates.

Budget: The Authority does not, and is not required to, have an appropriation budget.

**Tobacco Settlement Authority
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Notes to Financial Statements

Note 2. Deposits and Investments

Cash and cash equivalents as of June 30, 2012 included the cash balance of \$4,762,788 held by the Treasurer of State in pooled money funds and cash equivalents of \$19,867,477 invested in the open-ended mutual fund. Investments as of June 30, 2012 include the guaranteed investment contract of \$59,198,916.

Credit risk: Credit risk is the risk an issuer or other counterparty to an investment will not fulfill its obligation to the Authority. Under bond resolutions of the Official Statement of the Tobacco Settlement Asset-Backed Bonds, Series 2005, the Authority is authorized to invest in defeasance collateral; noncallable senior debt obligations of U.S. government-sponsored agencies that are not backed by the full faith and credit of the U.S. government; demand and time deposits in or certificates of, or banker's acceptances issued by, any bank or trust company, savings and loan association or savings bank; municipal obligations of any state of the United States or the State or any political subdivision thereof; commercial or finance company paper; repurchase obligations; securities bearing interest or sold at a discount issued by any corporation incorporated under the laws of the United States or any state, municipality or political subdivision thereof; units of taxable money market funds; investment agreements, forward delivery agreements, or guaranteed investment contracts rated, or with any financial institution or corporation; and other obligations, securities, agreements or contracts that are noncallable and are acceptable to each nationally recognized rating service agency.

The Authority's investments in the open-end mutual fund, the Treasurer of State's investment pool and the guaranteed investment contract are not subject to credit risk categorization.

Concentration of credit risk: Concentration of credit risk is the risk of loss that may be attributed to the magnitude of the Authority's investment in a single issue. The Authority places no limit on the amount that may be invested in any one issuer.

Custodial credit risk: Custodial credit risk for deposits is the risk the Authority's deposits may not be returned to it in the event of a bank failure. The Authority's deposits in financial institutions were covered by the Federal Deposit Insurance Corporation or by the State Sinking Fund in accordance with Chapter 12C of the Code of Iowa. The Authority's investments are all held by the State of Iowa or held by the State of Iowa's agent in the name of the Authority. The Authority's investments in the open-end mutual fund, the Treasurer of State's investment pool and the guaranteed investment contract are not subject to custodial credit risk.

**Tobacco Settlement Authority
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Notes to Financial Statements

Note 3. Bonds Payable

The Tobacco Settlement Asset-Backed Bonds were issued in five series: the Series 2005 A Bonds in the principal amount of \$222,910,000, which are federally taxable turbo term bonds, the Series 2005 B Bonds in the principal amount of \$159,368,793, which are federally tax-exempt turbo convertible capital appreciation bonds, the Series 2005 C Bonds in the principal amount of \$412,725,000, which are federally tax-exempt turbo term bonds, the Series 2005 D Bonds in the principal amount of \$15,775,344, which are federally tax-exempt turbo convertible capital appreciation bonds payable only when no current interest bond or convertible capital appreciation bond remains outstanding and the Series 2005 E Bonds, which are federally tax-exempt turbo convertible capital appreciation bonds, in the principal amount of \$21,182,893, which are federally tax-exempt turbo convertible capital appreciation bonds payable only when no current interest bond, convertible capital appreciation bond or Series D Bond remains outstanding.

The bonds bear interest at rates ranging from 5.375% to 7.125% pre annum and mature in varying annual amounts ranging from \$5,355,000 to \$360,990,000 with the final term and capital appreciation maturities due in the year ending June 30, 2046. The balance outstanding on June 30, 2012 was \$751,290,052 (\$1,290,065,000 net of unamortized bond discounts and deferred amounts of \$538,774,948).

The bond documents include the following provisions:

- (a) The Series 2005 Bonds are special revenue obligations of the Authority secured by, and payable solely and only out of, the monies, assets or revenues pledged by the Authority pursuant to the Indenture. The bonds are not a general obligation or general indebtedness of the Authority and do not constitute an obligation or indebtedness of the State or any political subdivision of the State. The Authority may not pledge the credit or taxing power of the State or any political subdivision of the State or create a debt or obligation of the State. The Authority has no taxing power. The Series 2005 Bonds constitute neither a general, legal or moral obligation of the State or any of its political subdivisions and the State has no obligation or intention to satisfy any deficiency or default of any payment of the bonds.
- (b) The Series 2005 A, B and C bonds are secured by and are payable solely from (i) 78% of the future amounts to be received by the State of Iowa under the MSA, (ii) investment earnings on certain accounts pledged under the bond indenture, (iii) amounts held in the debt service reserve account established under the bond indenture, (iv) amounts held in other accounts established under the Bond indenture and (v) certain rights of the Authority as specified in the sales agreement. Subject to the prior payment rights of the Series 2005 A, B and C bonds, the Series 2005 D and E bonds will be similarly secured and payable from the same sources, except the debt service reserve account will not be available as security.

**Tobacco Settlement Authority
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Notes to Financial Statements

Note 3. Bonds Payable (Continued)

- (c) The "Turbo Redemptions" of the term bonds represent the requirement to apply 100% of all collections which are in excess of requirements for the funding of operating expenses and the debt service account to the special mandatory par redemption of the Series 2005 Bonds on each distribution date in ascending order of maturity and pro rata within a maturity for the Series 2005 A Bonds and by lot within a maturity for all other Series 2005 Bonds.
- (d) The proceeds of the Series 2005 Bonds, except as deposited in the debt service reserve account, are not pledged to the payment of, and therefore are not available to the holders of, the Series 2005 bonds.
- (e) A bond fund is established with the bond indenture trustee and money will be deposited in the fund as provided in the bond indenture. The money will be held in trust and, except as otherwise provided in the bond indenture, will be applied solely to the payment of debt service. The bond fund includes the debt service account, the debt service reserve account, the extraordinary prepayment account and such other accounts as deemed necessary. The amount in the required debt service account is \$19,867,477 as of June 30, 2012.
- (f) The debt service reserve account was funded from bond proceeds in the amount of \$59,198,916. The account will be available to pay (i) the principal and interest on the Series 2005 A, B and C bonds to the extent collections under the MSA are insufficient and (ii) after an event of default, extraordinary prepayments. Amounts in the debt service reserve account will not be available to make (a) turbo redemptions on any bonds or (b) any payment of Series 2005 D or Series 2005 E bonds. Upon the occurrence of an event of default, the outstanding bonds will be prepaid pro-rata among all outstanding bonds and other unpaid amounts due on the bonds will be paid from available funds.
- (g) If an event of default has occurred, collections remaining after the payment of certain expenses and all current and past due interest on bonds will be deposited in the extraordinary prepayment account and will be applied, together with amounts in the debt service account, the debt service reserve account, the extraordinary prepayments account and the partial lump sum payment account, to the extraordinary prepayments of the bonds for principal or, in the case of capital appreciation bonds, the accreted value of outstanding bonds will be paid, in whole or in part, on each succeeding distribution date. The accreted value of capital appreciation bonds and any interest that has accrued will be payable only after all other bonds have been fully paid.

**Tobacco Settlement Authority
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Notes to Financial Statements

Note 3. Bonds Payable (Continued)

The Authority is subject to certain nonfinancial covenants related to the Series 2005 Bonds. The Authority is in compliance with these covenants.

Annual debt service requirements to maturity for the bonds are as follows:

Year Ending June 30	Series 2005 A Term Bonds			Series 2005 B Convertible Capital Appreciation Bonds		
	Principal	Interest Rate	Interest	Principal	Interest Rate	Interest
2013	\$ 105,635,000	6.50%	\$ 9,590,100	\$ -	5.60%	\$ 9,968,560
2014	36,550,000	6.50	2,723,825	-	5.60	9,968,560
2015	5,355,000	6.50	348,075	-	5.60	9,968,560
2016	-	-	-	-	5.60	9,968,560
2017	-	-	-	-	5.60	9,968,560
2018 - 2022	-	-	-	-	5.60	49,842,800
2023 - 2027	-	-	-	-	5.60	49,842,800
2028 - 2032	-	-	-	-	5.60	49,842,800
2033 - 2037	-	-	-	178,010,000	5.60	19,106,407
2038 - 2042	-	-	-	-	-	-
2043 - 2046	-	-	-	-	-	-
Total	\$ 147,540,000		\$ 12,662,000	\$ 178,010,000		\$ 218,477,607

Year Ending June 30	Series 2005 C Term Bonds			Series 2005 C Term Bonds		
	Principal	Interest Rate	Interest	Principal	Interest Rate	Interest
2013	\$ -	5.375%	\$ 5,561,781	\$ -	5.50%	\$ 7,431,600
2014	-	5.375	5,561,781	-	5.50	7,431,600
2015	-	5.375	5,561,781	-	5.50	7,431,600
2016	-	5.375	5,561,781	-	5.50	7,431,600
2017	-	5.375	5,561,781	-	5.50	7,431,600
2018 - 2022	-	5.375	27,808,906	-	5.50	37,158,000
2023 - 2027	-	5.375	27,808,906	-	5.50	37,158,000
2028 - 2032	-	5.375	27,808,906	-	5.50	37,158,000
2033 - 2037	-	5.375	27,808,906	-	5.50	37,158,000
2038 - 2042	103,475,000	5.375	5,098,304	135,120,000	5.50	36,538,700
2043 - 2046	-	-	-	-	-	-
Total	\$ 103,475,000		\$ 144,142,833	\$ 135,120,000		\$ 222,328,700

**Tobacco Settlement Authority
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Notes to Financial Statements

Note 3. Bonds Payable (Continued)

Year Ending June 30	Series 2005 C Term Bonds			Series 2005 D Capital Appreciation Bonds		
	Principal	Interest Rate	Interest	Principal	Interest Rate	Interest
2013	\$ -	5.625%	\$ 9,794,812	\$ -	6.25%	\$ -
2014	-	5.625	9,794,812	-	6.25	-
2015	-	5.625	9,794,812	-	6.25	-
2016	-	5.625	9,794,812	-	6.25	-
2017	-	5.625	9,794,812	-	6.25	-
2018 - 2022	-	5.625	48,974,060	-	6.25	-
2023 - 2027	-	5.625	48,974,060	-	6.25	-
2028 - 2032	-	5.625	48,974,060	-	6.25	-
2033 - 2037	-	5.625	48,974,060	-	6.25	-
2038 - 2042	-	5.625	48,974,060	-	6.25	-
2043 - 2046	174,130,000	5.625	38,363,014	190,800,000	6.25	-
Total	\$ 174,130,000		\$ 332,207,374	\$ 190,800,000		\$ -

Year Ending June 30	Series 2005 E Capital Appreciation Bonds			Total	
	Principal	Interest Rate	Interest	Principal	Interest
2013	\$ -	7.125%	\$ -	\$ 105,635,000	\$ 42,346,853
2014	-	7.125	-	36,550,000	35,480,578
2015	-	7.125	-	5,355,000	33,104,828
2016	-	7.125	-	-	32,756,753
2017	-	7.125	-	-	32,756,753
2018 - 2022	-	7.125	-	-	163,783,766
2023 - 2027	-	7.125	-	-	163,783,766
2028 - 2032	-	7.125	-	-	163,783,766
2033 - 2037	-	7.125	-	178,010,000	133,047,373
2038 - 2042	-	7.125	-	238,595,000	90,611,064
2043 - 2046	360,990,000	7.125	-	725,920,000	38,363,014
Total	\$ 360,990,000		\$ -	\$ 1,290,065,000	\$ 929,818,514

**Tobacco Settlement Authority
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Notes to Financial Statements

Note 3. Bonds Payable (Continued)

The following summarizes the bond payable activity for the Authority for the year ended June 30, 2012:

	Beginning Balance	Additions	Reductions	Ending Balance	Due Within One Year
Bonds payable:					
Term bonds	\$ 569,855,000	\$ -	\$ (9,590,000)	\$ 560,265,000	\$ 105,635,000
Convertible capital appreciation bonds	178,010,000	-	-	178,010,000	-
Capital appreciation bonds	551,790,000	-	-	551,790,000	-
Less deferred amounts:					
For issuance discounts	(17,829,059)	-	786,357	(17,042,702)	(774,797)
Capital appreciation discount	(498,516,294)	-	3,662,384	(494,853,910)	(3,916,207)
Deferral on refunding	(28,670,225)	-	1,791,889	(26,878,336)	(1,791,889)
Total bonds payable	\$ 754,639,422	\$ -	\$ (3,349,370)	\$ 751,290,052	\$ 99,152,107

Note 4. Deficit Net Asset Balance

The deficit net asset balance will be paid with future MSA revenues and investment income. The payments to be received by the State under the MSA represent a share of anticipated future sales of tobacco products. Although the Authority expects to receive certain amounts from the State, the collections are not assured.

Note 5. Tobacco Litigation Risk

The amount of revenue recognized by the State and provided to the Authority could be adversely impacted by certain third-party litigation involving tobacco companies and others.

**Tobacco Settlement Authority
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Notes to Financial Statements

Note 6. Current Accounting Developments

GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, issued July 2011, will be effective for the Authority beginning with its year ending June 30, 2013. This Statement is intended to improve financial reporting by providing citizens and other users of state and local government financial reports with information about how past transactions will continue to impact a government's financial statements in the future. This Statement provides a new Statement of Net Position to report all assets, deferred outflows of resources, liabilities, deferred inflows of resources, and net position (which is the net residual amount of the other elements). The Statement requires deferred outflows of resources and deferred inflows of resources be reported separately from assets and liabilities. This Statement also amends certain provisions of Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, and related pronouncements to reflect the residual measure of financial position as net position rather than net assets. Management is currently evaluating the impact on the Authority's financial statements.

GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*, issued April 2012, will be effective for the Authority beginning with its year ending June 30, 2014. This Statement clarifies the appropriate reporting of deferred outflows of resources and deferred inflows of resources to ensure consistency in financial reporting. GASB Concepts Statement (CON) No. 4, *Elements of Financial Statements*, specifies recognition of deferred outflows and deferred inflows should be limited to those instances specifically identified in authoritative GASB pronouncements. Consequently, guidance was needed to determine which balances being reported as assets and liabilities should actually be reported as deferred outflows of resources or deferred inflows of resources, according to the definitions in CON 4. Based on those definitions, this Statement reclassifies certain items currently being reported as assets and liabilities as deferred outflows of resources and deferred inflows of resources. In addition, the Statement recognizes certain items currently being reported as assets and liabilities as outflows of resources and inflows of resources. Management is currently evaluating the impact on the Authority's financial statements.